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Volume Title: Regularization of Business Investment

Volume Author/Editor: Universities-National Bureau

Volume Publisher: Princeton University Press/NBER

Volume ISBN: 0-87014-195-3

Volume URL: <http://www.nber.org/books/univ54-1>

Publication Date: 1954

Chapter Title: Government Measures Designed to Promote Regularization of Business Investment

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Chapter URL: <http://www.nber.org/chapters/c3031>

Chapter pages in book: (p. 451 - 458)

GOVERNMENT MEASURES DESIGNED TO PROMOTE REGULARIZATION OF BUSINESS INVESTMENT

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WHETHER it is "good business" to make a decision that helps toward economic stabilization is bound to depend partly on government policies in taxation, accounting rules, monetary arrangements, and the like. In terms of business cycle theory, the amplitude of fluctuations hinges largely on the sharpness of the "business response mechanism."

Thinking about government stabilization policy naturally focuses on ways to influence the "disturbances" to which business responds. Thinking about business policies that might contribute to stabilization focuses on what businessmen can do within an existing context. The topic of this paper is the area between—what government can do *to enlarge what business can do* toward economic stabilization.

To avoid drifting into a discussion of stabilization policy at large, I propose to limit myself to standing arrangements (as distinct from *ad hoc* measures), and to measures that affect business incentives in a given market situation (as distinct from measures that act directly on the market situation). In the monetary field, however, my discussion bulges out slightly beyond these limits.

Strengthening Business Incentives

By way of clearing the ground, we should draw a clear distinction between proposals for regularization and proposals for *intensifying* business incentives to invest or to offer employment. At this point, the economist diverges from the journalists and politicians who tend to set up as sovereign remedy for *either* inflation or unemployment a policy of enlarging business profits and increasing the availability of capital funds. Policies that have a general bias in favor of larger profits are perhaps more likely to be destabilizing than stabilizing, since they are apt to favor relying on current profits for financing and bunching investment more and more in peak periods.

It should be said, however, that intensifying incentives could contribute to regularization if linked with tough restrictions on investment. One possible regularization strategy is to cultivate an excess

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of demand over productive capacity and choke off part of the demand by direct controls—i.e., run a perpetual repressed inflation. Such intensification of incentives to invest could lead to regularization of investment by creating a queue of demanders for buildings, equipment, and so forth. In view of American attitudes toward direct controls, and of the well-known drawbacks of repressed inflation, it is hard to imagine our country deliberately adopting this strategy. The only way one can imagine our adopting it is to be forced into it—by devastation in case of war, or by an intense push toward industrial and residential decentralization for fear of atomic bombing.

Another possible regularization policy more compatible with American traditions would be to stimulate business investment and then use restrictive monetary policy (rather than direct controls) to screen out excess investment demand. This model is much like the image economists used to have of the role of investment banking in pacing investment to match “real” savings. If in any given period there were a constant backlog of profitable projects awaiting financing (held back, that is, by some combination of informal capital rationing and high interest rates), we could hope to regularize investment by calling projects up a little faster. Unfortunately, the real-life financial mechanism of a free enterprise economy tends to let through an inflationary volume of projects in boom times, and to end up without a backlog. But if the advocates of “strengthening business incentives” simultaneously advocated reforms to make monetary controls fully effective, they would have a policy combination of considerable promise.

Government Finance Possibilities

A number of public finance proposals point toward making it better business to regularize investment. Built-in fiscal flexibility (a structure that automatically tends toward deficit in recession and toward surplus in recovery) would encourage stability. Its stabilizing effect via consumer expenditure is ruled out of this discussion as being a “market” measure. But its tendency to reduce fluctuations in retained profits may be classified as an “incentive” measure.

A fascinating question is whether a special tax could create incentives to abate inventory fluctuations. It is easy to set up a recipe for a tax with appropriate incentive effects. An example would be a tax at a substantial rate (25 per cent, say) to be applied each quarter to the value of any increase *or* decrease in each firm’s inventory,

compared with the same date a year previously. Presumably, small changes (less than 5 per cent of the base inventory, say) would be exempt.¹ At the cost of some complication, the regularization characteristics of the tax could be improved by raising the exempt percentage of increase whenever unemployment exceeded a stated level. My rather fragmentary knowledge of the problems of valuation, administration, and compliance involved suggests that this scheme is impractical; but some students of the problem are more optimistic.²

Another interesting-if-feasible project is to design a tax on price increases. In times of expansion or boom, the stabilization characteristics of the economy are apt to be better if firms confronted with increased demand do not resort to price increases too readily. So long as sellers can fill orders at existing prices by taking up unemployed resources, society gains by having them do so. As bottlenecks appear, it may be desirable from the standpoint of resource allocation to have price increases at the tightest points. But on the whole, the tendency of many sellers to lengthen delivery dates and fatten their order books is probably a healthy one.³ If the growth of demand proves transitory, the period of full-volume operations is apt to be prolonged, and there will be longer notice of the exhaustion of the extra demand. Accordingly, a tax on the gross proceeds of any price increase might be very desirable. But I suspect that such a tax would shatter on the difficulty of evaluating quality changes, and hence of measuring price increases in individual cases.⁴

Merit-rating systems of unemployment compensation may be significant from the standpoint of business regularization incentives.

¹ Such an exemption would avoid putting tax penalties on normal growth, gradual liquidation, or *trends* in business policy concerning inventories. The number of taxpayers could be further reduced, and growth of small firms encouraged, by exempting a moderate *dollar amount* of change per firm, even though it exceeded the exempt percentage.

² See, for instance, the comment below by D. G. Tyndall.

³ The economic-stabilization characteristics of this response would be still better if an increase of orders on the books led to a tying up of liquid funds—for instance, if sellers took substantial payments on order, but were obliged to impound them in liquid form rather than add these receipts to working capital. There may be scope here for social invention; but I have been unable to frame a rule that sounds workable to govern such deposits.

⁴ Index-number calculation, as I understand it, deliberately concentrates on a small number of prices for which quality specifications are unusually definite. A tax of this sort would have to cope with the hard cases as well as the easy ones—in the face of a substantial incentive to confuse the issue by linking price rises with changes in quality.

I share the view of many economists that the countercyclical fluctuation of employers' contributions implicit in the schemes of most states is objectionable. But as Drs. Schmidt and Abramovitz pointed out in discussing the original version of this paper, a merit-rating scheme may have the effect of subjecting an employer to a fairly substantial fine for a specific layoff of workers. This effect (or a dismissal compensation scheme) may swing the balance in favor of meeting fluctuations of demand by stockpiling output, rather than by having a margin of plant capacity and letting output and employment fluctuate. It also points toward force-account investment in slack times as a way to use workers to whom an employer is committed.

On the expenditure side of public finance, there is a whole family of plans for government stockpiling. These plans are primarily on the market rather than the incentive side, and thus need only incidental mention here. But it should be mentioned that any such plan tends to make it safer to hold inventories of the commodities affected. For highly standardized commodities, therefore, we can be sure that to introduce a government demand for inventory will not cause an *equal* reduction in private demand for inventory and will have a net stabilizing effect. I am more skeptical, however, about proposals (such as that of Lerner and Graham) to generalize the stockpiling idea by offering to buy unsold storable goods at direct cost. Government stocks of unstandardized goods could be cleared only through the normal channels of their producers and would thus "overhang the market" just as much as private stocks. In effect, the scheme is no more than an offer to finance inventory accumulation, and this is not enough to keep a flagging of orders from reducing production schedules.

The most important fiscal possibilities for investment regularization probably lie in the corporate income tax. Not every change here is an improvement. A sterling example of the fallacy I referred to above, of identifying incentive intensification with stabilization, is the proposal for optional timing of depreciation. This would clearly encourage bunching investment outlays in years when investment could be charged off against profit. A two-edged change has been the introduction of lifo accounting for inventory. *Thinking* in terms of lifo is an antidote to the tendency to mistake fictitious inventory gains and losses for real swings in earnings, and thus to feel unduly complacent on the upswing and unduly discouraged on the downswing. On the other hand, *paying taxes* in terms of lifo rather than

fifo means less taxes on an upswing and more on a downswing, and thus increases the bunching of internal finance possibilities at the crest of the cycle. Whether official sanction of lifo does more good under the first head than harm under the second is hard to guess.

Averaging income over good and bad years for tax purposes should tend to regularize investment, since it reduces the danger that depreciation may run to waste if a depression occurs after a large investment. But here, as with lifo, there is a problem of the date when funds become available. The recent tendency in tax legislation has been to average by carrying forward past losses and setting them against present profits. The resulting tax benefits take the form of tax abatement in the early years of a prosperity. From the standpoint of regularization characteristics, averaging by carrying back current losses and setting them against previous profits is more attractive. This system involves a sobering absorption of funds into the Treasury in high prosperity, offset by refunds when depression sets up losses. One's judgment on this problem must hinge largely on the question of whether greater availability of funds early in a depression would help significantly to combat the contraction of investment. (I opine that it would, but do not pretend my argument is conclusive.) Weight must be given also to the fact that carry-forward is more helpful to new firms, and carry-back to moribund firms. But I suspect that the superior time shape of the flow of tax funds under carry-back has not been given the weight it deserves in framing tax policy.

Monetary Possibilities

By general consent, one of the great destabilizing forces in our economy is the relation between banking and business. If business is guided on the upswing by the belief that it will prove easy to borrow, and on the downswing by the belief that bankers are unwilling to lend, the amplitude of fluctuations is bound to be enlarged.

A partial remedy for this source of instability is to continue the post-1933 trend toward cyclically insensitive standards of bank supervision, and toward amortized loans without lump-sum maturities. More fundamental would be a convincing demonstration that henceforth the authorities will keep bank reserves tight in booms and avoid pinching them in depressions. Unfortunately, the record (including that of recent years) encourages the expectation that the authorities will conduct an easy-money policy in booms, and tighten up (if ever) in recessions.

Influences on Expectations

The context of business decisions includes the influence of government on expectations—not merely through forecasts of future conditions, but above all, through indications about future government actions. Analysis of the fiscal and monetary possibilities sketched above will show that if the timing of their results is satisfactory, it will be because of the expectations they set up. There are also a few other influences acting through expectations that need analysis.

Our recent patterns of policy toward wages and farm prices lead periodically to situations where increases of 10 per cent or more are visibly in the making for a few months preceding their announcement. Such an expectation of imminent cost increases makes it apparently foolproof to stock up, and rash to postpone buying, and thus can generate top-heavy inventory booms. Experience in 1936-1937 and since the war suggests that this sort of environment warps business decisions in a destabilizing direction.

More generally, the context of business decisions will depend largely on the business view about the design and effectiveness of the government's stabilization policy. If fluctuations are apt to be severe, a recession is a moment to suspend investment; a boom is a time when investment is in arrears, and must be hurried forward. If fluctuations are known to be under control, a slump is an opportunity to invest at reduced cost and with reduced interference with regular operations. On the whole, then, if businessmen think regularization is succeeding, they will tend to plan their business bets so as to help toward regularization; if they are skeptical that regularization is succeeding, they will place their bets so as to make regularization more difficult.⁵

It is tempting to infer (with Beveridge) that the way to make regularization easy is to enlist the support of business expectations by *announcing* regularization. Unfortunately, economic life is full of surprises. If we rely too heavily on this announcement effect, the surprises that ensue will be apt to convince the public that regularization policy is ill designed or ill executed. The only secure way to operate is with a margin of safety—both in the range of tolerance

⁵ An important exception is embodied in Vickrey's Paradox. It seems likely that much of the present-day demand for cash balances rests on fears of a depression. If these fears were allayed, release of excess cash might prove seriously inflationary. So "the problem of stabilization is first to stabilize in the face of the public's doubts that it can be done, then to keep stability from being overthrown by the public's belief that it has been achieved." We must hope confidence will not spread too suddenly.

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for fluctuations in output and prices, and in the measures adopted to keep the economy within this range of tolerance. A somewhat wider range of fluctuations in output than we have experienced since World War II (and a narrower range of price fluctuations) should be officially recognized as tolerable. Measures adopted should be strong enough to keep fluctuations within tolerance limits even though many business firms bet that these limits will be exceeded. Once experience has proved to businessmen that regularization policy is working, we can hope that business responses will carry much of the load.

C O M M E N T

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One important effect of government policy can hardly be over-emphasized. If the cost aspects of investment could be raised in importance relative to its revenue aspects, it should help promote regularization. If businessmen could be induced to use a longer pay-off period in their calculations, the state of product demand in the near future would be less important relative to the supply prices of assets. If businessmen are convinced that declines in g.n.p. and employment of severe duration or amplitude will be prevented by public policy, they will think in terms of a longer investment horizon and will not fear cyclical declines in demand as much as they now do. Since costs of capital goods vary directly with the cycle, investment would be discouraged in expansions and encouraged in contractions. Thus greater cyclical regularization of private investment is a likely by-product of public contracyclical policy.

DAVID GORDON TYNDALL, American President Lines

Professor Hart mentions, as a "dramatic example" of the possibilities of regularization of business investment, a tax on inventory change but then dismisses the "gadget" as "unadministrable." I would argue that the plan is by no means unadministrable and that, if its full effectiveness is to be realized, the tax should apply to deviations of gross investment in plant and equipment from the average of the preceding (say) five years, as well as to inventory changes. This form of the tax, however, would have the disadvantage of penalizing rapidly expanding firms. On this and other grounds there would be distinct advantage in a variant of Professor Hart's tax, namely, a tax on gross investment (including change in inventory) that would

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be varied with the level of unemployment in the economy: it would be negative when unemployment is high, positive when unemployment falls below the "inflation-producing" level.

I have discussed elsewhere (*Journal of Finance*, December 1949) the advantages of such a tax over more orthodox fiscal and monetary devices and some of the administrative problems connected with such a tax. I will only point out here that, whichever variant is used and whether the tax is applied only to the inventory change or to a broader base, the valuation problem to which Professor Hart avers can be solved easily (though perhaps not optimally) by following the practice of the Bureau of Internal Revenue. The determination of costs, which are deductible from gross revenue for purposes of computing income subject to tax, implicitly determines change in inventory and other categories of gross investment. Of course, there would be administrative problems with this, as with any other, tax, but there is no reason to believe that they would be insuperable.